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Basel Core Principles and Bank Soundness

There is no robust statistical evidence linking better compliance with Basel Core Principles and greater bank soundness

The recent financial crisis has exposed significant weaknesses in the regulatory and supervisory framework for banks and led to a debate about the role these weaknesses may have played in causing and propagating the crisis. As a result, reform of regulation and supervision is a top priority for policy makers, and many countries have already reformed their frameworks or are working to upgrade them. But there are still more questions than answers: What constitutes good regulation and supervision? Which elements are most important for ensuring bank soundness? What should the reforms focus on?

The Basel Committee, made up of bank supervisors, has been trying to answer these questions since 1997, when it first met to issue the *Core Principles for Effective Bank Supervision*, a document summarizing best practices in the field. Since then many countries have endorsed the Basel Core Principles and undertaken to comply with them, making them an almost universal standard for bank regulation. Since 1999 the International Monetary Fund (IMF) and World Bank have conducted evaluations of countries' compliance with these principles, mainly within their joint Financial Sector Assessment Program. Thus the international community has made significant investments in developing

these principles, encouraging their widespread adoption, and assessing progress in compliance with them.

In light of the recent crisis and the resulting skepticism about the effectiveness of existing approaches to regulation and supervision, it is natural to ask whether compliance with the global standard of good regulation is associated with bank soundness. Demirgüç-Kunt and Detragiache examine this question in a recent paper. Specifically, they test whether better compliance with the core principles is associated with safer banks. They also look at whether compliance with different groups of core principles is more closely associated with bank soundness, to determine whether there are specific areas that could be priorities for reform efforts to improve supervision.

Compliance ratings can be informative. They are available for the 25 core principles, which cover all aspects of regulation and supervision—including the availability of a legal framework and resources for supervisory agencies, powers of supervisors, licensing criteria and permissible activities for institutions, all prudential regulations (such as capital adequacy and risk management practices), methods of ongoing supervision, information requirements, and supervision of cross-border activities. Importantly, the assessments are supposed to take into account not only the laws and regulations but also the extent to which they are implemented in practice. For this

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Financial Globalization: Shifting Balances

Identifying whether global imbalances are good or bad, and thus which policy mix can address them, is not straightforward

A conference brought together scholars and policy makers in Madrid on July 1–2, 2010, to discuss financial globalization issues in the context of the recent financial crisis. Sponsored by Banco de España and the World Bank's Office of the Chief Economist for Latin America and the Caribbean, with the academic support of the Centre de Recerca en Economia Internacional (CREI), the conference focused on three main themes: the nature of current patterns of financial globalization (that is, global imbalances), how financial systems around the world might have shifted with the recent turmoil, and the role of local markets and financial intermediaries in this volatile environment. It featured 10 academic papers, a keynote speech by Olivier Blanchard, and a panel session on Latin America with Carmen Reinhart, Augusto de la Torre, and Rodrigo Valdés.

Some countries have large current account surpluses, and others large deficits, leading to global imbalances that reflect diverse macroeconomic and financial factors. As Olivier Blanchard emphasized, these imbalances are neither good nor bad in themselves. Cross-country differences in savings patterns, investment patterns, and portfolio choices simply reflect differences in development levels, demographic patterns, and other fundamentals. For example, countries with attractive investment opportunities or deeper and more liquid markets attract foreign savings and thus run current account deficits. Global imbalances in this scenario would be the outcome of an optimal allocation of capital and therefore desirable.

Global imbalances might also reflect distortions and externalities at

national and international levels. High domestic savings, for example, may reflect poor corporate governance or lack of social insurance in domestic financial systems. And because of systemic distortions, for example, export-led growth might not be sustainable if countries representing a large fraction of world trade adopt such a strategy. In these scenarios countries should opt for policies aimed at reducing the distortions rather than the imbalances.

In practice, identifying whether global imbalances are good or bad, and thus which policy mix can address them, is not straightforward. Conference participants found that even “good” imbalances can interact with domestic and international market distortions, leading to inefficient outcomes or increasing risks to financial systems.

The recent global financial crisis brought to our attention aspects of the global financial system that were not evident before. Pierre-Olivier Gourinchas, Nicolas Govillot, and Hélène Rey highlighted the role of the country at the center of the global financial system as an insurance provider. The United States enjoys an “exorbitant privilege” (a higher return on its external assets than on its external liabilities) in part because of the role of the dollar as a reserve currency. Such a privilege significantly weakens the external constraint the country faces by allowing it to run large current account deficits without a significant deterioration in its external position. But to the extent that the United States provides safe assets to the rest of the world, it also has an “exorbitant duty” to act as an insurer against global shocks in times of turbulence. During the recent period of turmoil there was a transfer of wealth from the United States to the rest of the world as the value of its foreign assets declined with the collapse of financial markets around the globe and the value of its external liabilities increased.

The aftermath of the Lehman

Brothers collapse suggested a retrenchment of financial flows around the globe. Fernando Broner, Tatiana Didier, Aitor Erce, and Sergio Schmukler presented new evidence based on gross (rather than net) capital flows suggesting that this phenomenon is not unique to this crisis. During periods in which a country faces a currency, banking, or debt crisis, a general retrenchment in capital flows—with both domestic and foreign investors reducing their exposures to foreign markets—is observed. This finding suggests that financial crises affect domestic and foreign investors asymmetrically. It also stands in contrast with theories defending fire sales of domestic assets to foreigners during financial crises and with those arguing that the dynamics of capital flows are driven by productivity shocks when there are no differences in endowments.

The role of domestic financial systems in ameliorating both national imbalances (usually associated with domestic financial crises) and international ones was also discussed during the conference. John Burger, Francis Warnock, and Veronica Warnock presented new evidence on the development of local bond markets in emerging economies during the 2000s and the simultaneous reduction in the use of foreign currency bonds as a source of financing. U.S. investors have contributed by shifting their investments toward local markets. Participation in local markets tends to be higher in countries with investor-friendly policies and institutions, suggesting that domestic policies can help attract foreign capital. These findings suggest, therefore, that the development of local markets in developing countries might mitigate a shortage of investable assets worldwide (a feature of global imbalances).

Papers, presentations, and the conference program can be found at <http://www.bde.es/homee.htm> under “Conferences and Seminars.”

Fiscal Competition in Developing Countries

Do fiscal incentives attract foreign direct investment—and do they benefit the host country?

The sharp growth in foreign direct investment (FDI) has led to increased competition and bidding races among developing countries to attract these flows. Host governments compete in a range of ways, including by offering productivity-enhancing public infrastructure or tax holidays and other investment incentives. Such competition can take place between national governments or between local governments within a country. In a new paper Madiès and Dethier survey the recent theoretical and empirical literature on this phenomenon in developing countries, asking whether there is empirical evidence of strategic behavior by developing-country governments to attract FDI and whether FDI flows to developing countries are sensitive to tax incentives.

Intergovernmental competition arises because a firm's decision to locate in a region creates benefits for that region (knowledge spillovers and employment). The basic model—a noncooperative game in which, at the Nash equilibrium, tax rates are too low and public goods are underprovided—would implicitly assume that governments maximize payoffs for their citizens. But if resources are diverted and payoffs to government bureaucrats are maximized instead, the firm may end up in the country where private (rather than public) value is highest.

Many papers represent variations on this theme. For example, if the firm chooses its location in period 1 but is free to relocate in period 2, its mobility will still be limited when there is uncertainty about its productivity because building a plant represents a sunk cost. The region where the firm locates can extract part of the surplus produced in subsequent periods, without fear of the firm being bid away to another region. The subsidy received

by the firm is increasing in the level of sunk cost, and decreasing in the disparity of the expected productivity between regions. A consequence is that “bidding wars” are more likely to occur when competing regions are not differentiated from each other.

The literature on fiscal competition generally shows that when governments compete by offering public infrastructure that increases the productivity of private firms, public goods may be overprovided and tax rates too high—leading to a “race to the bottom.” But there are also situations that reduce tax competition and would not lead to a race to the bottom.

One of these is inertia resulting from agglomeration effects. Fiscal competition does not necessarily lead to tax rates that are “too low,” since the mobile factor is concentrated and produces a taxable rent. The agglomeration rent is bell-shaped in trade openness: economic integration, characterized by lower transport costs, at first reduces, then increases, the intensity of fiscal competition. Agglomeration effects, and thus the taxable rent, are the highest for intermediate transport costs—costs that are sufficiently low to make agglomeration happen and sufficiently high for spatial concentration to be a necessity.

At equilibrium, the tax gap is also bell-shaped. Starting from a low level of openness and making trade freer first increases the tax gap, then decreases it. Core countries can engage in a tax game in which they set a tax rate sufficiently low to make the periphery countries abandon the idea of trying to attract the core.

Because of greater economic integration, fiscal incentives have become increasingly important for FDI location. These incentives do not require direct payment of scarce public funds and are popular in developing countries. But are they beneficial to the host countries? This question largely boils down to whether externalities associated with FDI are important enough to

justify fiscal incentives. The evidence compiled by the literature points to the potential for significant spillovers from FDI and the fact that most developing countries lack the human capital and technical capability to generate these spillovers.

Empirical studies of the elasticity of FDI with respect to tax incentives, conducted in all regions of the world, show that corporate tax differentials play a significant part in driving FDI flows. Impact is not symmetric, since low tax rates fail to significantly attract FDI while higher taxes tend to discourage new FDI inflows. The composition (but not the level) of public expenditures matters. Higher public investment expenditures increase FDI flows. Market potential also matters.

A “race to the bottom” is not necessarily the more likely outcome when developed or developing countries compete for foreign investment with fiscal incentives. Differences in endowments and public infrastructure may lead to such an outcome in some regions but to a “race to the top” in others. Fiscal incentives matter more in attracting FDI from developing than from developed countries.

Because most developing countries offer fiscal incentives to foreign investors, there is a risk that fiscal resources will be wasted, since generally only one country wins. A better strategy would be to set a low, stable corporate income tax rate to attract FDI from developed countries and to improve other features, including governance and the education of the labor force, which ultimately matter more than fiscal incentives.

Thierry Madiès and Jean-Jacques Dethier. 2010. “Fiscal Competition in Developing Countries: A Survey of the Theoretical and Empirical Literature.” Policy Research Working Paper 5311, World Bank, Washington, DC.

Inheritance Laws and Women's Empowerment in India

Granting women inheritance rights equal to men's increases their access to physical and human capital

That improving women's position relative to men's is desirable not only on equity but also on efficiency grounds is an argument often advanced in favor of policies targeted toward women. While developing countries continue to improve equality of economic opportunity for women, inheritance law remains strongly biased against women in many societies. When the distribution of inherited wealth is highly unequal, the effect of this disparity on economic inequality is of great interest.

At low levels of development, land is a key asset and an essential source of livelihood. So it is not surprising to find that societies have long developed rules to govern how land is transferred across generations. Women's ability to inherit land is often restricted. Widows and daughters often possess only temporary rights to land, leading to lower productivity and greater likelihood of being affected by land conflict. In light of evidence documenting the importance of asset ownership for women's bargaining power, their opportunities to earn a livelihood, and intrahousehold allocation of resources toward consumption and investment, constraints on women's legal rights to property are likely to be at the root of broader patterns of inequality.

While the underlying social and cultural dynamics are complex, legal reform to improve women's inheritance rights could potentially provide a low-cost way to reduce gender discrimination and improve a range of socioeconomic outcomes for women. State-level reform of inheritance laws in India provides an interesting natural experiment for exploring whether and to what extent such efforts have been effective. In 1994 the states of Karnataka and Maharashtra amended the Hindu Succession Act, granting

daughters equal shares in inheritance relative to sons. The results of the reform could provide potentially important lessons for India, where similar, national-level changes were made in 2005, and for countries where inheritance rights remain severely biased against women.

The passage of sufficient time since the amendment was enacted, and the availability of unique data over three generations, allow assessment of the impact of the legal change on women's asset endowment and socioeconomic outcomes. In a new paper Deininger, Goyal, and Nagarajan use data from the 2006 nationally representative Rural Economic and Demographic Survey, conducted by the National Council of Applied Economic Research, on 1,371 rural Hindu households in Karnataka and Maharashtra. The survey contains detailed information on the parents, siblings, and children of household heads, providing quantitative measures of intergenerational transfers of both physical and human capital investments. A difference-in-differences strategy was used to estimate the impact of the new law, comparing the inheritance of land by males and females from fathers who died before and after the amendment of the act in the two states.

The authors find that while the amendment did not fully eliminate the underlying inequality, it increased women's likelihood of inheriting land by 22 percentage points. Even in cases where the actual inheritance is not yet observed, the fact that a woman can expect to inherit property may increase her bargaining power or affect her marital prospects. Indeed, the authors find a robust increase in women's age at marriage (by 0.5 years) after the reform, and women achieved better outcomes in the marriage market, such as marrying at a later age, marrying a more educated spouse, and being able to make favorable reproductive decisions.

The results also point to a positive and significant impact on women's educational attainment. Girls who started

their education after the amendment came into force had 0.3 years more of elementary education in 2006. This suggests a genuine improvement in women's status, rather than a substitution away from human capital to physical capital transfers by parents to their daughters following the legislative amendment.

Estimated effects appear to increase over time, which can be attributed to learning about the content of the amendment. This suggests that in India better dissemination of the 2005 national legal change could significantly improve women's status.

Legal barriers to women's ability to inherit property often put women at a strong disadvantage and may be at the root of broader patterns of inequality. Indeed, stronger inheritance rights for women are likely to be a potent mechanism for improving a range of outcomes. This paper is the first attempt in the economic literature to estimate the impact of legislative changes in inheritance rights on women's lives in India. It shows that while more gender-equal inheritance rights did lead to positive effects for women, it did not fully eliminate the underlying gender inequality.

Klaus Deininger, Aparajita Goyal, and Hari Nagarajan. 2010. "Inheritance Law Reform and Women's Access to Capital: Evidence from India's Hindu Succession Act." Policy Research Working Paper 5338, World Bank, Washington, DC.

Subjective Well-Being and the Duration of Unemployment

Because of comparison effects, one person's labor supply decisions often take into account the labor supply of others

Can subjective well-being predict the length of unemployment? In a recent paper Mavridis explores this question using a panel data set from the United Kingdom that follows more than 10,000 individuals over 16 years.

The author shows that upon losing their job, individuals report a fall in their well-being. This fall is greater than that predicted by the loss of income. There are large nonmonetary drawbacks to being laid off. But this drop in well-being is reduced when there are more unemployed in one's comparison group (household and region), a phenomenon referred to as the social norm effect.

While the comparison effect is strong, it differs by gender. Women suffer more than men when their spouse is made redundant. But men compare their situation more, both with that of their spouse and with that of their regional peers. When men lose their job, they suffer, but they suffer less if their spouse is also unemployed. The comparison effect is less strong for women (table 1).

The duration of unemployment is affected by this social norm. The more hurt an individual reports feeling upon the loss of his job—the bigger the drop in happiness—the shorter the duration of his unemployment will be. Going one step further, the author argues that job search behavior also depends on the social norm, on the individual's perception of how socially stigmatizing unemployment is. Job search effort is itself dependent on the happiness difference. An individual reporting a large drop in happiness upon entering unemployment searches for a new job with greater intensity.

Modeling the duration of unemployment shows that age, gender, region, and educational achievement all seem to be correlated with

unemployment duration and that monetary incentives also play a significant role as the deadline of benefits exhaustion approaches. On top of these traditional determinants of duration, however, the author finds that the initial drop in happiness associated with losing one's job can predict how long a person will stay unemployed. Those reporting a large loss of happiness spend less time unemployed than those reporting a smaller loss or none at all.

These findings suggest that one person's employment decisions have a strong externality on the labor supply and job search effort of others, through comparison effects. Upon one person's losing a job, if a relevant other is also jobless, both individuals search with less intensity. In the opposite scenario, if all relevant others are employed, search intensity increases for the unemployed.

This mechanism helps in explaining the rise in women's participation rates in the 20th century. It also explains why the jobless rate might remain higher in regions with high unemployment than in those with low unemployment, or why it may take longer to fall. Explanations of unemployment hysteresis (the fact that unemployment

rates depend on their past level) have centered on labor demand. The author's findings suggest that unemployment hysteresis might also come from labor supply behavior. If others are unemployed, people will search less and extend their unemployment duration, in turn affecting the return to work by others. The recent economic downturn pushed unemployment rates to their highest level in two decades. The recovery has so far been a "jobless recovery." The results presented by the author suggest that a labor supply story can be consistent with these facts. When unemployment abounds, the comparison effect makes it harder for the jobless rate to recover, creating hysteresis.

Many policy implications arise. One concerns the responses to exogenous macroeconomic shocks. Following a labor demand shock, as unemployment rises, the labor supply might also fall (shift to the left) through a comparison effect. This suggests the need for a policy response to correct for this externality in times of high unemployment.

Dimitris Mavridis. 2010. "Can Subjective Well-Being Predict Unemployment Length?" Policy Research Working Paper 5293, World Bank, Washington, DC.

Table 1. Well-Being and Others' Labor Force Status

Variable	Answer to General Health Questionnaire (index)					
	All	Men	Women	All	Men	Women
Self-employed	-0.081 (-1.68)	-0.146 (2.63)**	0.035 (-0.38)	-0.078 (-1.6)	-0.0145 (2.60)**	0.034 (-0.36)
Unemployed	-1.114 (5.68)**	-1.542 (6.80)**	-0.48 (-1.29)	-1.44 (14.39)**	-1.79 (13.67)**	-1.006 (6.64)**
Regional unemployment rate	-0.002 (-0.26)	0 (-0.03)	-0.005 (-0.46)	-0.003 (-0.42)	0.001 (-0.09)	-0.007 (-0.64)
Spouse employed = 1	0.155 (4.31)**	0.035 (-0.87)	0.403 (5.31)**	0.185 (5.10)**	0.079 (1.97)*	0.415 (5.41)**
Interaction: spouse unemployed* respondent unemployed				0.496 (3.36)**	0.801 (4.69)**	0.139 (-0.44)
Interaction: regional unemployment* respondent unemployed	-0.022 (-0.84)	0.017 (-0.59)	-0.08 (-1.43)			
All other controls	Yes	Yes	Yes	Yes	Yes	Yes
Constant	11.029 (6.65)**	13.103 (8.76)**	9.579 (5.17)**	10.96 (6.62)**	13.002 (8.71)**	9.56 (5.16)**
Observations	80,850	42,746	38,104	80,850	42,746	38,104
R-squared	0.45	0.45	0.44	0.45	0.45	0.44

Source: Data from British Household Panel Survey, 1991–2006.

Note: Ordinary least squares with fixed effects. Absolute value of *t*-statistics in parentheses.

** Significant at the 1 percent level.

The Automotive Industry in Developing Countries

Could local automakers leverage the global supply base to rapidly become more competitive locally—and perhaps globally?

Foreign direct investment in developing countries by large multinational firms has accelerated dramatically since the late 1980s in a range of industries. At first these investments were mainly for export back to the developed world, but more recently the focus has shifted to burgeoning local markets as well. A common view of global value chains of this sort is that innovation and design functions—the higher value added activities in the chain—can remain in industrial countries while production migrates to the developing world. In this “win-win” scenario firms in developing countries can upgrade their capabilities by participating in global value chains while knowledge-intensive jobs continue to grow at home. As a result, trade and investment rules have been liberalized to support the development of global value chains.

Yet national- and regional-scale production has remained durable in some industries, and knowledge work is gradually coming under greater pressure from globalization. In the automotive industry political pressure, in the form of indirect, latent protectionism, drives automakers to hedge their bets by locating production as close to end markets as is practical. Because automakers are few in number and therefore powerful, they have been able to force their largest suppliers to follow them abroad as they have globalized. This facilitates just-in-time production and design collaboration. It provides local content. But it makes it hard for local suppliers in developing countries to compete.

Indeed, as Sturgeon and Van Biesebroeck argue in a recent paper, policy makers in the developing world seeking to cultivate the automotive industry have limited options. Political opposition to large-scale finished

vehicle imports, combined with high minimum efficient scale in production, means that local market size dictates the potential for the industry’s growth. The dream of a viable, full-blown national automotive industry lies beyond the reach of all but the very largest developing countries, such as Brazil, China, and India. And even in these countries it seems inevitable that multinational firms will continue to dominate the domestic industry for a long time to come.

But the authors suggest that there are several other avenues open for development. First, a few midsize developing countries, such as South Africa, Thailand, and Turkey, are large and rich enough to support vehicle assembly for their domestic markets as long as they can export to their wider regions as well. Second, several developing countries are close enough to developed countries to supply parts on a just-in-time basis within regional trade blocs, such as Mexico in NAFTA and several Eastern European countries in the European Union. These countries have become export hubs for labor-intensive parts and more recently for low-cost vehicles as well.

Third, a nascent possibility is for local automakers to leverage the new, relatively open global supply base to rapidly become more competitive locally and, perhaps, in world markets. For example, Chery Automobile, a small, state-controlled company based in Wuhu, China, has been able to develop and market a line of Chery brand vehicles within a remarkably short time by tapping the expertise of first-tier global suppliers with operations both in China and in the West. Chery obtains a full range of inputs from the global supply base, from parts to production equipment to design and system integration expertise. But since learning is relatively shallow, the sustainability of Chery’s approach will need to be proven over the long term.

Even when local firms have opportunities to move up the automotive global value chain, learning tends to be slower than in other industries

because new vehicle programs typically have four- to six-year life cycles. In addition, winning significant new contracts with multinational assemblers can require that suppliers collocate engineering work in or near the world’s main automotive design centers: southeast Michigan, Stuttgart, and Tokyo/Nagoya. Such investments are beyond the reach of local suppliers in poor countries.

Nevertheless, as the markets for motor vehicles shift to the developing world and production inevitably follows, more development and design work will shift as well. The automotive cluster in Shanghai has only a few important design centers so far, but local Chinese firms are trying hard to fill the vacuum. In India domestic firms have deeper engineering capabilities, and the small, bare-bones vehicles that dominate the local market comprise a segment that has eluded most multinational firms so far. It remains to be seen whether these vehicles can be successfully exported. The prospects for local companies in automotive global value chains are still less promising than in other industries, but the future could eventually become significantly brighter.

Timothy J. Sturgeon and Johannes Van Biesebroeck. 2010. “Effects of the Crisis on the Automotive Industry in Developing Countries: A Global Value Chain Perspective.” Policy Research Working Paper 5330, World Bank, Washington, DC.

Social Protection in Latin America: The Unfinished Revolution

Many of Latin America's social protection systems have been transformed in the past two decades. There is more to do

During the recent financial crisis Latin American governments announced temporary expansions of safety net programs such as Brazil's Bolsa Família and Mexico's Programa de Empleo Temporal. While final data are not yet available, it has often been claimed that such measures helped protect the poor from the worst effects of the recession.

Viewed from a long-term perspective, the fact that large cash-based programs such as these existed in Latin America in the first place seems remarkable. Until the early 1980s social assistance in the region consisted almost exclusively of food and energy subsidies. There were also some direct feeding programs as well as small transfer programs for narrowly defined vulnerable groups such as the disabled.

Separately, most countries also had introduced Bismarckian social insurance systems, consisting of old-age, disability, and survivorship pensions as well as health insurance benefits. Such systems, which date to the early 1920s in the Southern Cone and the 1940s in Mexico and most other countries in Latin America, cover workers with formal employment and are financed primarily by mandatory contributions from employers and employees. In most countries coverage never really extended beyond the urban formal sector and therefore excluded the overwhelming majority of the poor.

A recent paper by Ferreira and Robalino examines the evolution from this truncated welfare state, which largely excluded the poor and redistributed income among the middle classes, to a range of modern systems that have greater resources and coverage but remain poorly integrated and still face real challenges in promoting both security from shocks and opportunity for prosperity.

In the late 1980s and early 1990s the convergence of need and opportunity spurred policy innovation. Need arose as a result of the debt crisis and the subsequent structural adjustment policies, which were accompanied by deep recessions and substantial increases in poverty. Opportunity, at least in such countries as Argentina, Brazil, and Chile, came with political redemocratization. Although there is little evidence of a master plan, the paper argues that the expanded social assistance systems in the 2000s center on three pillars: noncontributory social insurance programs, conditional cash transfers, and workfare schemes (alongside improvements in the provision of in-kind transfers, such as food and nutrition programs).

Noncontributory social pensions are entitlement programs that extend the right to regular payments, such as an old-age pension, to a predetermined population without requiring any previous contribution history or imposing any current condition. Their coverage may be defined by age alone (as in Bolivia's Bono Solidario, which makes a fixed transfer to all citizens age 65 or older), or there may be some means testing (as in Brazil's Benefício de Prestação Continuada). These are often large programs that have a measurable impact on current poverty even if their incidence is less progressive than that of conditional cash transfers.

Conditional cash transfers are payments made to parents (usually the mother) as long as certain conditions associated with their children are met. These usually include a minimum school attendance rate and, in some cases, conditions relating to health care. Although the transfers are typically small, their incidence is usually quite progressive, even in countries where the programs now cover a quarter of the population, as in Brazil and Mexico.

Workfare programs have an established history in the region, going back to Chile's Programa de Empleo Mínimo in the 1980s. More recently they have reemerged as an important

safety net for urban unemployed who are not entitled to formal unemployment insurance. During Argentina's deep 2002 recession, for example, its Jefes y Jefas de Hogar reached some 11 percent of the labor force.

The transformation that many of the region's social protection systems have undergone in the past two decades should not be underestimated. Conditional cash transfers and social pensions now deliver reliable payments to some of the poorest people in Bolivia's *altiplano*, Brazil's *sertão*, and the forests of southern Mexico—people and places that seldom received assistance from their governments 20 or 30 years ago. Equally important, this quiet revolution has resulted from homegrown policy innovation—particularly for conditional cash transfers—and stronger political will in many countries, most of which are now robustly democratic.

Yet the paper concludes on a cautionary note: the organic nature of the growth in social assistance implies that the existing systems, though larger, remain inefficient in many ways. Poor integration between social insurance and social assistance has led to increasing labor market distortions. Poor integration among individual social assistance programs also means that policies form less safe a net than they might to protect the poor from shocks and less effective an "opportunity rope" than they could. Much has been achieved, but the quiet revolution is far from complete.

Francisco H. G. Ferreira and David A. Robalino. Forthcoming. "Social Protection in Latin America: Achievements and Limitations." In Oxford Handbook of Latin American Economics, ed. José Antonio Ocampo and Jaime Ros. New York: Oxford University Press.

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purpose, evaluations are conducted by expert supervisors with international experience and are reviewed for consistency by internal teams at the IMF and World Bank.

The paper looks at the impact of compliance with the core principles on bank soundness, covering 3,000 banks from 86 countries. Bank soundness is captured using the Z-score, a measure of distance to default defined as the number of standard deviations by which bank returns have to fall to exhaust bank equity. Using accounting data allows the authors to explore whether the relationship between compliance with the core principles and bank soundness varies across different types of banks.

Overall, the authors fail to find any robust evidence that better compliance with the core principles is associated with sounder banks. This result holds after controlling for the macroeconomic environment, institutional quality, and bank characteristics. And it holds for different samples focusing only on rated banks, on commercial banks, or on the largest financial institutions. Additional tests, calculating aggregate Z-scores at the country level to try to capture the stability of the system as a whole, reveal that systemic stability is not significantly related to overall compliance with the core principles either.

When the authors explore the relationship between soundness and compliance with specific groups of principles, relating to separate areas of prudential supervision and regulation, they again find no evidence that good compliance is related to improved soundness. If anything, the results indicate that stronger compliance with principles related to the power of supervisors to license banks and regulate market structure is associated with riskier banks.

These results may reflect the difficulty of capturing bank risk using accounting measures, or the inability of assessors to carry out evaluations that are comparable across countries despite the best efforts of expert supervisors and internal reviewing teams at the IMF and World Bank. If these results arise because reported compliance assessments do not reflect reality as a result of political difficulties, they should at a minimum lead us to question the value of these assessments and whether there are ways of improving them.

Demirgüç-Kunt, Asli, and Enrica Detragiache. Forthcoming. "Basel Core Principles and Bank Soundness: Does Compliance Matter?" *Journal of Financial Stability*.

Recent Policy Research Working Papers

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